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The Greek Crisis

The imposition of capital controls in Greece follows yet another failure to reach a compromise with the IMF, the ECB and the European Union on Sunday evening. Eurozone finance ministers refused to let Greece extend the bailout program and as a result the ECB has halted its emergency loan program for Greece.

The referendum scheduled for this Sunday is effectively a vote on whether the Greek population would prefer to stay in the Eurozone and by the same token, a vote against the current Greek leadership.

There are two alternatives: A negative vote on Sunday will probably lead to a 'Grexit' and default on all external debt. An affirmative vote could cause maintenance of capital controls and the introduction of a parallel currency denominated in Euros. The parallel currency scenario could result in an eventual Grexit. With the introduction of capital controls and bank withdrawal limits, Greece's interaction with the rest of Europe could become increasingly dysfunctional. A benign scenario in which Greece gradually lifts capital controls and remains in the Euro can only be accomplished through bank recapitalization which requires further negotiation between Greece and its creditors. It would also require actions by the European stability mechanism (ESM).

A realignment of domestic political interests within Greece is a necessary condition for constructive progress to be made. The main constituency of the present government, pensioners and public employees, has enjoyed first claim on the government's hard currency cash reserves. These reserves will soon be exhausted given that the small primary surplus of the Greek federal budget is likely to be wiped out and wages and pensions will eventually have to be funded with government IOUs rather than Euros. The public is unlikely to trust these IOUs as a store of value which could have extreme inflationary consequences. Once the government has to resort to IOU payments, many of its constituents may cease to support the current government and may become more positive about structural reforms.

While markets may react poorly in the short term, it is important to note that the majority of Greek debt (nearly 80%) is held by public rather than private entities and therefore contagion risk is limited. It is also true that the ECB remains ready to address any short term liquidity risks if they arise.

The Greek question has been the focus of the Eurozone crisis since 2011. Unfortunately, Greece's finances were not even strong enough to meet the minimum Euro entry requirements in 1999. The fact is that

Greece has improved its fiscal situation over the last few years and is actually running a primary surplus (which was about .7% of GDP in 2014). It has also become more competitive given the decline in its unit labor costs. While the long-term questions regarding Euro membership for Greece and other peripheral countries such as Spain and Portugal remain, we expect that efforts to keep the Eurozone together will be the priority for European leaders and they are prepared and equipped to do so.

If you have questions about the economic situation in Greece and Europe, please contact our team directly at lerskine@drexelmorgancapital.com or 610-971-1901. We are monitoring the events closely and will provide you with additional updates as appropriate.

Disclosures